No. 210

IN THE

Supreme Court of the United States

(October Term, 1945)

P. G. LAKE, Inc.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For a Writ of Certiorari to the United States Circuit Court of Appeals For The Fifth Circuit

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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I.

Respondent seeks to distinguish the decision of the Circuit Court of Appeals for the Sixth Circuit in *Musselman Hub-Brake Company v. Commissioner*, 139 F. (2d) 65, from the decision of the Court below in the instant case on the ground that notes were issued by the debtor in the cited case within the prescribed period (Brief 6). On this basis, respondent avers that the two decisions are not in "direct conflict" (Brief 6).

The fact that notes were issued by the debtor in the *Musselman* case in no way alters the inexorable conclusion that a direct conflict exists in the two decisions, as may be seen from the following considerations:[1]

1. Section 24(c)(1) uses the word "paid." This Court has previously held that the giving of a note by a debtor is not a payment in cash or its equivalent for purposes of the bad debt or loss provisions of the taxing acts. *Eckert v. Burnet*, 283 U. S. 140, and *Helvering v. Price*, 309 U. S. 409. A fortiori, the giving of notes by the Musselman Hub-Brake Company did not and could not constitute a payment in cash, and "the giving of the taxpayer's own note was not the equivalent of cash." *Helvering v. Price*, supra, at page 413.

Respondent, as did the Court below, interprets the word "paid" as used in Section 24(c)(1) to mean liquidate in cash (Brief 10). It was for this reason that respondent expressed his belief that the "Musselman decision was wrong." (Brief 6). This is a plain admission by the respondent that the two decisions are in direct conflict, for it recognizes that the notes executed by the Musselman Company constituted nothing more than a form of constructive payment.

[1]This should be considered in the light of the fact that petitioner here had its own notes outstanding promising to pay interest as well as principal (R. 46). Lake, the payee, had the immediate right to enforce the payment of this interest on Jan. 1, 1940. In the **Musselman** case, the notes extended the time of payment.

The Musselman Hub-Brake Company was in the same identical economic, factual and legal position, so far as payment to its creditor is concerned, as was your petitioner who, it must be remembered, had already executed notes to its creditor for the principal of the debt, which notes according to their terms promised to pay the interest here sought to be deducted. (R. 46). In neither case (except as to the amount covered by Petitioner's Specification No. 3, Pet. 7) was there an actual cash payment to the creditor. In both cases, the debtor, to bring itself within the purview of Section 24(c)(1), had to rely upon the doctrine of constructive payment. This doctrine was accepted by the Sixth Circuit Court of Appeals. It was rejected by the Court below. The decisions are in irreconcilable conflict.

2. The Sixth Circuit Court of Appeals in the most explicit language considered the controlling question to be "the applicability of the rule of constructive payment." (139 F. (2d) at p. 69). That Court likewise held that the debts were so paid when they "constituted income actually or constructively received by the creditor." (139 F. (2d) at p. 68). Constructive receipt of income by a creditor can and does occur whether he obtains notes from his debtor or not. (See Sec. 19.42-3, Regs. 103, Appendix Pet., p. 23-24). The decision by the Sixth Circuit Court of Appeals that constructive payment satisfies the requirements of Section 24(c)(1) cannot, therefore, on grounds of substance and reality, be said not to be in conflict with the decision of the Court below.

3. The Tax Court of the United States has cited and applied the Musselman decision as authority for the proposition that constructive payment satisfies the requirements of Section 24(c)(1). *Nock Fire Brick Company*, entered April 21, 1945, C. C. H. Decision 14,527(M); *Lectrolite Corporation*, entered April 20, 1945, C. C. H. Decision 14,530(M). In neither of the last cited cases were notes given by the debtor to the creditor. Obviously, therefore, the ground upon which respondent seeks to differentiate the *Musselman* case from the instant one is considered by the Tax Court as of no moment or importance.

II.

While admitting that the Tax Court decisions under Section 24(c) are in conflict, (Brief 8) respondent states that "it is unecessary to resolve any conflict in its decisions in this case, for under no theory of constructive receipt was there such a receipt here." (Brief 8). Respondent then states that "The constructive receipt doctrine is based upon the fact that a person is free by his own action or inaction to reduce money to his control and possession." (Brief 8). Employing this test, it is manifest that Lake was in constructive receipt of the interest in question under the following controlling facts:

1. The interest was due and payable January 1, 1940.

2. The obligation to pay was admitted and unconditional.

3. This obligation was then set up on the books of petitioner as a payable then due.

4. The petitioner had ample unappropriated cash with which to pay the interest throughout the two and one-half months period.

5. This interest was due to petitioner's President, P. G. Lake.

6. Lake had unlimited authority to check upon petitioner's account for any proper purpose without counter-signature.

7. All that Lake had to do to collect physically this interest on January 1, 1940, or any time thereafter, was to draw a check therefor.

These undisputed facts make out a conclusive case of constructive receipt. Nothing more than the Regulation is required to support this. "Income * * * set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart." The item of income "must be available to him so that it may be drawn on at any time, and its receipt brought within his own control and disposition." "His own control and disposition" is the key phrase. That Lake did have such control and power of disposition is obvious when all that he had to do to effect a physical collection was to write a check. Could Lake have defeated respondent's attempt to tax him on this interest in 1940 had it not been physically paid to and resported by Lake in that year? That is a fair test, and the only answer to the inquiry is that Lake could not have avoided reporting the interest in 1940, even though he had not actually or physically collected it in that year.

Respondent's assertion that "There can be no constructive receipt without an unconditional credit on the books of the debtor in favor of the creditor, and the interest in the instant case was not credited to Lake on the taxpayer's books * **" (Brief 8) is unfounded. It is unfounded, first, because "Undrawn salary may be constructively received even where not credited where the taxpayer was the controlling shareholder and could have withdrawn the salary without financial embarrassment to the corporation."[2] The Treasury Department makes no credit on its records of interest due on unregistered United States bonds. Yet, the holder of such a bond is in constructive receipt of income when the interest coupon becomes due, even though not cashed and even though not credited to him on the books or records of the Treasury Department.[3]

The above quoted assertion from respondent's brief is unfounded, second, because the interest in question was set up in an "accrued interest payable" account on the books of the petitioner from month to month as it accrued. This account included only interest upon the indebtedness due Lake. The amount of the

[2]Merten's **Law of Federal Income Taxation**, Vol. 2, paragraph 10.13, page 21. The same principle is, of course, as applicable to interest as to salary. See also **A. R. R. 4385**, II-2 Cum. Bull. 81.

[3]Sec. 19.42-3, Regs. 103: "If interest coupons have matured and are payable, but have not been cashed, such interest, though not collected when due and payable, shall be included in gross income for the year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year."

accrual was treated and considered by petitioner and Lake as an unconditional obligation due by petitioner to Lake. It cannot be said, therefore, that an unconditional credit in favor of the creditor on petitioner's books was not made.

The case of *Jenkins v. Bitgood*, 101 F. (2d) 17 (C. C. A. 2) certiorari denied 307 U. S. 636, cited by respondent for the proposition that constructive receipt is not correlative with payment (Brief 8) involved the right of a taxpayer to a loss deduction where notes of the taxpayer, who was on the cash basis of accounting, were not paid within the taxable year. This is the same type of situation considered by this Court in *Helvering v. Price*, supra, and is no authority on the problem in the case at bar. (See footnote 5, Pet.).

III.

Respondent's statement in his brief that the "Tax Court has not always been consistent in its various holdings under Section 24(c) * * * (Brief 8) strongly supports petitioner's Reason II (Pet. 11-16, incl.) for granting the writ; viz, the Court below decided an important question of federal law which has not been, but should be, settled by this Court.

The Tax Court's inability consistently to decide the cases arising under Section 24(c) is due to lack of authoritative rules of guidance. This unhealthy situation has been accentuated by the conflict existing in the decisions of the Sixth Circuit Court in the *Musselman* case, supra, and of the Fifth Circuit Court of Appeals in the instant case. The uncertainty and

chaos resulting from the conflicting decisions has permeated the administration of this statute, leaving Government and taxpayer alike on infirm and uncharted ground. The situation requires action by this Court, not only to resolve the existing conflicts but to prevent those that will inevitably arise, as indicated by the course of the decisions of the trial and appellate courts. (Pet. 12 et seq.).

CONCLUSION

For the reasons herein given, as well as those contained in the Petition for Writ of Certiorari, it is respectfully prayed that said petition be granted.

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